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TREASURY PLEASE PASS TO OCC (ESIEGEL) AND FEDERAL RESERVE  
USDOC PLEASE PASS TO OITA  
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SUBJECT: Austria's Economic Footprint in Central Europe  
and the Balkans

Summary

1. Austrian commercial interests continue to benefit greatly from intensified trade and investment relations with the countries of Central and Eastern Europe (CEE), as well as Southeastern European (SEE) nations. Exports to CEE have more than doubled since 1995 and exports to SEE have quadrupled. In 2004, more than 50% of Austrian Foreign Direct Investment (FDI) went to the region, and Austria was the largest foreign investor in Slovenia, Croatia, Bulgaria, Romania and Bosnia-Herzegovina. Austrian banks and insurance companies are particularly dominant in CEE and SEE, with 25% and 20% market shares respectively. Other sectors, notably financial services, telecoms, and energy, also have active expansion strategies in the region. Austria views its commercial presence in the Balkans as a contributing factor to economic growth and political stability in the region. During its EU Presidency the first half of 2006, Austria will promote increased contacts between the EU and Balkan nations, as well as accession for Romania and Bulgaria in 2007. End Summary.

"Enlargement Bonus" for Austrian Economy

2. Austria's economic relations with the countries of Central and Eastern Europe (CEE) have soared since the opening of CEE markets in 1989. Austrian business took advantage of opportunities in CEE at an early stage, with Austrian banks providing the financial underpinnings for significant export and FDI growth. Economists estimate that new market opportunities in CEE stimulated an additional growth rate of 3.3% in Austria from 1989 to 1997, and created approximately 60,000 new jobs. The 2004 accession of eight CEE countries to the EU accelerated Austria's eastward focus. Austrian exporters benefited from dynamic import growth in the new EU member states, creating a "win-win-situation", according to the Vienna Institute for International Economic Studies (WIIW). With only 2% of the EU's population, Austria has 8% of EU-internal trade with the new CEE member states. Austria's competitiveness and productivity has improved due to the EU's eastward enlargement. Extensive economic relations with CEE have also helped Austria to overcome sluggish demand from traditional export markets, especially Germany, in the Eurozone.

Impressive Trade Growth in CEE and the Balkans

3. Austrian exports to CEE more than doubled from \$5.3 billion (10.4% of Austrian exports) in 1995 to \$13.3 billion (12.3% of exports) by the end of 2004. In Southeastern Europe (SEE), exports have more than quadrupled from a low base of \$935 million (1.9% of total exports) in 1995 to \$4.3 billion (4.0%) in 2004. In 2004, seven of Austria's 17 most important export markets were located in CEE and SEE, headed by Hungary, the Czech Republic, Slovenia and Poland. Equally impressive, Austrian imports from CEE rose from \$3.7 billion (6.3% of Austrian imports) in 1995 to \$11.5 billion (10.5% of imports) in 2004. Imports from SEE increased from \$370 million (0.6% of total) in 1995 to \$2.0 billion (1.9%) in 2004.

Thriving Austrian FDI

4. In the past ten years, Austria's FDI has shifted markedly towards CEE and SEE. In 2004, more than 50% of Austria's FDI went to CEE and SEE. In 2004, Austria was the number one foreign investor in Slovenia (30% of all FDI flow into Slovenia), Croatia (23%), Bulgaria, Romania

and Bosnia-Herzegovina. Austria held the second position in Serbia-Montenegro, and third in Slovakia, Hungary and the Czech Republic. Austrian FDI to the EU-15 has correspondingly dropped from 46% of total FDI in 1995 to 34% in 2004.

#### Austrian Banks and Insurance Dominant in CEE and SEE

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15. Austrian banks have been active in CEE since the mid-1980s, spearheading Austrian FDI in those countries. Since 2000, Austrian banks have also moved aggressively into SEE markets, considered "an extended domestic market." Western European banking groups control some 70% of the CEE and SEE banking markets. Austrian banks hold approximately 25% of the market, by far the largest portion, followed by Italian banks with half that share. In several countries in the region, Austrian banks' market share is more than 40%.

16. Six out of Austria's seven largest banks hold huge investments in CEE and SEE: Bank Austria Creditanstalt (BA-CA), Erste Bank, Raiffeisen International (RI), BAWAG, Volksbanken (VAG), and Hypo Alpe-Adria Bank (HAAB). Among the five largest foreign banking groups in the area, three are Austrian: (Erste Bank is number one, BA-CA number two, and RI number four). Erste Bank overtook BA-CA as the largest bank in the region following its December 2005 acquisition of 62% of Romania's largest bank, Banca Comerciala Romana, for Euro 3.75 billion.

17. Austrian insurance companies have about 60 CEE/SEE subsidiaries. Since the low insurance density offered high growth potential, Austrian insurance companies also moved into these markets early. Contrary to banking sector investment in the region, which is predominantly M&A, the insurance industry has concentrated on greenfield investments. Austrian insurance companies hold a market share of 15-20% in CEE and SEE and earn 30% of their total premiums from operations in the region.

#### Vienna Stock Exchange Expands in Region

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18. In March 2005, an Austrian consortium, led by the Vienna Stock Exchange (VSE), acquired a majority share in the Budapest Stock Exchange (BSE). This was an initial move in VSE's strategy to form a broader "Central European Stock Exchange" alliance, including the VSE, BSE, and stock exchanges in Warsaw, Prague, Bratislava, Ljubljana and Sofia. The VSE's strategy complements the expansion of Austrian banks, insurance companies and other business into the new EU member states and other CEE and SEE countries.

#### Energy, Telecommunications, and Infrastructure

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19. Austrian energy and telecom providers also hold sizable investments in CEE and SEE. The Austrian energy provider EVN purchased two-thirds of the Bulgarian Government's "South-East" in November 2004. The Austrian petroleum giant OMV's purchase of 51% in the Romania petroleum company PETROM in December 2004 for \$1.8 billion was the biggest Austrian FDI ever at that time. In July 2005 Telekom Austria took over the Bulgarian company Mobiltel for \$1.9 billion, with plans to become the biggest telecom provider in SEE. The Austrian Economic Chamber and the Vienna Economic Forum (VEF), a platform promoting investments in SEE, foresee continued investment opportunities, particularly in infrastructure.

#### Austrian Airlines - CEE/SEE Network Carrier

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10. The Austrian Airlines (AUA) group has positioned itself as a network carrier for CEE and SEE to support Austrian business in the region. From its hub at the Vienna airport (VIE), AUA currently operates 461 flights weekly to 39 destinations in 23 CEE and SEE countries. In January 2005, AUA obtained a 62% share in Slovak Airlines (SA) as part of its CEE strategy. In December 2005, the Slovak Privatization Commission recommended the sale of the Bratislava and Kosice Airports for Euro 367 million to a consortium led by VIE. VIE has further signaled interest in obtaining shares in the Zagreb airport, once Croatian authorities privatize it.

#### Opportunities.

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11. There remains considerable potential for Austrian commercial expansion in CEE and SEE. Aside from geographical proximity and historical ties, Austrian investors benefit from high growth prospects in the

region. There will continue to be a strong demand for banking products. Moreover, for Austrian banks, which suffer from high costs and relatively low interest income in their domestic market, the CEE/SEE subsidiaries are cash cows, with CEE/SEE profits representing a large portion of operating income.

#### .and Risks

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12. Eastward expansion also involves risks, including political instability, legal uncertainties, and corruption. Some Austrian firms and banks are becoming increasingly dependent on growth and future developments in these markets. The huge exposure of the Austrian banks' CEE/SEE subsidiaries entails additional risks: macroeconomic imbalances in the region, exchange rate volatility, credit risks, increasingly fierce competition, and necessary consolidation of the banking sector in CEE/SEE. Providing banking supervision at Western European standards remains a challenge.

#### Politics Follows Economics

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13. Austrian banks are contributing to the stabilization of CEE/SEE financial systems. This, in turn, helps foster market-oriented reforms and economic progress, as well as political stability. GoA representatives pointed out during a recent forum that Austria tries to define itself as a "focal point" for business with SEE and as a mediator to stabilize SEE politically. Close commercial ties with SEE also explained the GoA's strong support for commencing EU membership negotiations with Croatia. During its EU Presidency the first half of 2006, Austria will push for intensified contacts between the EU and the Balkan region. Austrian Minister of Economy Martin Bartenstein recently confirmed Austria's strong interest in the EU accession of Romania and Bulgaria in 2007 and in closer EU relations with SEE, "the European growth champion."

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